



Approved by  
Decision of Board of Directors of "Kubanenergo",  
JSC  
Minutes of meeting No. \_\_  
dated \_\_\_\_\_ 2012

Regulations on Internal Control  
of "Kubanenergo", JSC  
(restated)

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## 1. General provisions

1.1. Internal Control Policy of “Kubanenergo” (hereinafter - the Policy) is developed in accordance with the legislation of the Russian Federation, the Charter of “Kubanenergo” JSC (hereinafter - the Company), the Code of Corporate Governance, other internal documents of the Company and is based on the recommendations of best world practices in the sphere of internal control system.

1.2. The policy is an internal document of the Company and determines the procedures, objectives and principles of the system of internal control, roles, responsibility and interaction of the participants, the types and levels of internal control over business activity of the Company.

1.3. Regulations on the Policy are obligatory for use in all departments of the Company.

## 2. Definitions

**Internal control** - is a process aimed to provide reasonable assurance in achieving the strategic and operational goals of the Company, effective and efficient use of resources of the Company, the safeguarding of assets, observance by the Company of the requirements of Russian legislation, industry standards, internal regulations of the Company and the provision of reliable reporting.

**Internal Control System** – is the range of procedures, methods and control mechanisms that are created by the executive authorities and the Board of Directors to ensure effective implementation of the internal control over financial and economic activities.

**The risk management system** – is a set of procedures, techniques, information systems aimed to achieve the goals and objectives of risk management.

**Control procedures** - a set activities aimed at eliminating (reducing) the probability of the risk for the Company. Control procedures are an integral part of the Company's business processes.

**Checkpoints** - control criteria that connect risk factors of the business process with the strategic goals and objectives of the Company's business process.

**The participants of the internal control system** - The Board of Directors, the Audit Committee, the Audit Committee of the Board of Directors, Chief Executive Officer, the Management Board of the Company, Department of the internal audit and risk management, as well as officers and employees of the Company, responsible for the implementation of control procedures attached to them by internal documents of the Company.

**The Company** - “Kubanenergo” JSC

**Department** - division in the organizational structure of the Company.

Affiliated and dependent company - the subsidiary of “Kubanenergo” JSC engaged in the electricity transmission, technological connection to grids, retail energy, energy service and repair work.

**Department for internal audit and risk management.**

**Business process** - is a stable, targeted, controlled set of related operations, ordered by time and the performers, with precise entry and exit of the business process.

**Risk** - uncertainty in achieving the goals of the Company. As part of this document a risk (risk event) means a likely event that could affect the achievement of the strategic and operational objectives of the Company.

**Risk matrix and control procedures** - a document that describes the process control environment in the form of a table that contains a description of the steps of the process, a description of the process and a description of risk control procedures.

**COSO** - The Committee of Sponsoring Organizations of the Treadway Commission - is a voluntary private organization established in the United States and designed to make appropriate recommendations to corporate leadership on critical aspects of organizational management, business ethics, financial reporting, internal control, risk management and fraud prevention companies.

**Conceptual framework COSO Internal Control** - Model COSO defines internal control as a process carried out by the Board of Directors, management and other company personnel, designed to provide "reasonable assurance" in the strategic and operational objectives of the Company.

**COSO ERM** - Enterprise risk management model of the Committee of Sponsoring Organizations of the Treadway Commission, widely used in the world for risk management.

**Internal Audit** - activities aimed at assessing the reliability and efficiency of risk management system and system of internal control of the Company.

### **3. Aims of system of internal control**

The system of internal control of the Company (hereinafter – ICS – Internal Control System) – is the full range of procedures, methods and controls that are created by the executive authorities and the Board of Directors to ensure effective implementation of the internal control over financial and economic activities. ICS is the element of the corporate governance of the Company.

The main aims of ICS are:

1. Improving the corporate governance of the Company and subsidiaries to provide reasonable assurance of compliance with the rights and interests of shareholders and investors of the Company and subsidiaries in respect of:

- the effective and efficient use of resources of the Company and subsidiaries;
  - the soundness of assets of the Company and subsidiaries;
  - the compliance with legislation of Russian Federation, internal Regulations of the Company and subsidiaries (compliance control);
  - the accuracy, objectivity of management and accounting (financial) control and reliability of system of their preparing.
2. Improving the efficiency and effectiveness of activity of the Company and subsidiaries through improvement of process of risk management and implementation of the effective controlling procedures.
  3. Assistance of timely adaptation of activity of the Company to changes of internal and external environment..

#### **4. Basis of the organization of the internal control**

##### 4.1. ICS in system of corporate management

ICS is one of the elements of Company's system of corporate management that provide the adoption of informed decisions by management bodies of the Company, decisions aimed to increasing of shareholder value of the Company by increasing the degree of responsibility and accountability of members of corporate management system at all levels of Company's management.

Upgrading of ICS realizes by Company in subsidiaries using methods of corporate management as part of implementation of rights of subsidiary's shareholder and based on principals described in present Policy.

Control over financial and economic activity of subsidiaries is carried out by Company according to Company's Charter.

##### 4.2. Principles of organization of internal control system

The basis of effective and reliable functioning of Company's internal control system is the observance of the principles of ICS:

- integrity: ICS– is a part of Company's management system of all levels;
- complexity: ICS seizes all Company's areas of activity, control procedures are carried out in all business processes on every level of management system;
- continuity of operation: permanent effective activity of system of internal control allows to prevent the possibility of violations and risks and identify them in time;
- responsibility: all participants of ICS are responsible for proper implementation of control procedures within their remit vested in the by-laws of the Company;

- impartibility of responsibility: responsibility for the execution of each control procedure is fixed for only one participant of ISC in accordance with segregation of functional responsibilities in Company;
- segregation of responsibility: responsibilities are shared on the basis of separation of powers for the implementation of functions: the initiation, authorization, execution accounting and control for the execution of business transactions;
- unity of methodological procedures: activity of system of internal control is carried out on the basis of common approach and standards on all levels of corporate management of Company;
- transparency: disclosure of information for interested parties in full volume;
- regulatory activity: control procedures at all levels of management and in all business processes are formalized by local and internal documents of the Company;
- documenting: the results of the financial and business operations and control procedures in the Company recorded and stored in a proper way;
- authorization: all financial and business operations in the Company should be authorized (approved) and permitted by officials within their competence;
- endowments: control procedures are endowed with resources and powers for their execution;
- practicability: control procedures are carried out according to their practicability and cost-effectiveness, in other words the expenditures for implementation of control procedures do not exceed the impact of their implementation, which is expressed in the reduction of risk;
- development and improvement: control procedures are continuously being improved and adapted to changes in the internal and external environments;
- conformity and interaction: the execution of control procedures and improvement of ICS based on effective and coordinated cooperation of all ICS participants at all levels of management of the Company.

#### 4.3. Components of system of internal control

According to the model ICS system COSO internal control consists of five interrelated components. These components provide an effective basis for the description and analysis of the internal control system implemented in the Company. Five components include:

1. Control environment;

2. Risk assessment;
3. Control procedures;
4. Information and communications;
5. Monitoring.

Description of the elements of each of the components of ICS is shown in Table 1. Table 1. Components of internal control

<b>Component of ICS</b>	<b>Elements of internal control in Company</b>
The control environment	<p>Corporate governance code of the Company approved by Board of the Directors of the Company (Minutes meeting dd. 01.11.2006, No. 23/2006):</p> <ul style="list-style-type: none"> <li>– Ethical principles;</li> <li>– Internal policy and procedures.</li> </ul> <p>Corporate structure:</p> <ul style="list-style-type: none"> <li>– identification of related and consistent goals and objectives at different levels of management of the Company;</li> <li>– distribution and delegation of key authority and responsibility of the Company, effective interaction of divisions and employees of the Company;</li> </ul> <p>The distribution of powers and responsibilities:</p> <ul style="list-style-type: none"> <li>– verification system of reference according to which employees perform their functions;</li> <li>– separation of key responsibilities among employees of the Company (including duties for approval and approval of financial and business transactions, recording transactions, issuing, storage and generation of resources, analysis and verification of operations);</li> <li>– informing all employees about their responsibility and duties in the area of internal control;</li> </ul> <p>Personnel policy:</p> <ul style="list-style-type: none"> <li>– professional skills and competencies of employees;</li> <li>– recruitment procedure;</li> <li>– performance assessment of employees;</li> <li>– training.</li> </ul>

<b>Component of ICS</b>	<b>Elements of internal control in Company</b>
	<p>Documentation of business transactions and their reflection in the system accounts.</p> <p>Local and regulatory documents of the Company.</p>
Assessment and analyze of risks	<p>Risk management cycle is defined by Risk Management Policy of "Kubanenergo" JSC, approved by the Board of Directors (Minutes dd. 31.05.2010, No. 90/2010).</p>
Control procedures	<p>Revision (subsequent) - procedures to identify gaps in processes and adverse events after the fact of they have occurred.</p> <p>Directive – procedures to identify forward procedure for employees of the Company.</p> <p>Remedial - procedures to make corrective actions before or after a negative event.</p> <p>Preventive - procedures that would remove or reduce the likelihood of a sharp negative events.</p> <p>Compensating - procedures to compensate the lack of monitoring.</p>
Information and communication	<ul style="list-style-type: none"> <li>– establishing a system for collecting, processing and transmission of information, including reports and messages preparation containing information about the financial, economic and other activities of the Company, as well as the establishment of effective channels of communication and to ensure vertical and horizontal communication links within the Company</li> <li>– establishing effective communication between the Company and third parties;</li> <li>– access to information from internal and external sources;</li> <li>– identification, registration, bringing to stakeholders necessary management information;</li> <li>– informing the employees about present policy of Company, plans, instructions etc.</li> </ul>
Monitoring	<ul style="list-style-type: none"> <li>– definition of criteria and evaluation of the structural units, officers and employees of the Company;</li> <li>– risk-based audit of business processes;</li> <li>– audit;</li> <li>– correspondence analysis of actual value of financial and business activity and planned values;</li> </ul>



<b>Component of ICS</b>	<b>Elements of internal control in Company</b>
	– regular self-assessment of the quality of the internal control system.

#### 4.4. Distribution of duties and responsibilities of participants of internal control system

Table 2 contains the distribution of duties and responsibilities of participants of ICS.

**Table 2. Distribution of duties and responsibilities of participants of ICS**

<b>Participant</b>	<b>Duty</b>	<b>Functions and responsibilities</b>
<b>Board of the Directors</b>	<b>Funder</b>	<ul style="list-style-type: none"> <li>– defines the required level of development of ICS;</li> <li>– approves and makes changes in the internal control policy;</li> <li>– gives instructions to the executive bodies of the areas of improvement and development of ICS.</li> </ul>
<b>Audit committee of Board of the Directors of Company</b>	<b>Inspector</b>	<ul style="list-style-type: none"> <li>– oversees the effectiveness of ICS, including evaluates the effectiveness of ICS;</li> <li>– provides compliance oversight of compliance of the legislation of the Russian Federation and the internal regulations;</li> <li>– analyzes the annual financial statements (accounts), including assessment of the auditor's report before its submission to the Board of Directors and interim (quarterly) financial (accounting) statements before its disclosure;</li> <li>– takes into consideration reports of Sector for Internal Control and Risk Management about results of completed control events and control procedures in the frame of estimation of efficiency of ICS and Sector of Risk Management;</li> <li>– prepares proposals (recommendations) to improve the ICS interaction with the Audit Committee.</li> </ul>
<b>Director general (management board)</b>	<b>Assurer</b>	<ul style="list-style-type: none"> <li>– organizes and is responsible for the effective functioning of the ICS in the Company.</li> </ul>
<b>Officials</b>	<b>Managers</b>	<ul style="list-style-type: none"> <li>– provides the realization of principles of ICS;</li> <li>– manage and own the business process;</li> </ul>

Participant	Duty	Functions and responsibilities
		<ul style="list-style-type: none"> <li>– responsible for the effective achievement of the operational goals of business processes;</li> <li>– organize the effective controlling environment of business processes, including ensuring the availability of effective control procedures and the "embedding" of control procedures in the business processes of the Company and the implementation of the prior and current control;</li> <li>– provide timely inclusion of control procedures developed by Sector for Internal Control and Risk Management to local regulatory documents governing the activities of reporting units / business process and job descriptions of employees reporting;</li> <li>– manage the risks of business processes and organize the implementation of control procedures of business processes.</li> </ul>
<p style="text-align: center;"><b>Subdivision of internal audit and risk management</b></p>	<p style="text-align: center;"><b>Expert-inspector, Coordinator-Methodologist</b></p>	<ul style="list-style-type: none"> <li>– perform the follow-up control in the Company;</li> <li>– organize events to assess the effectiveness of the immediate ICS and Sector of Risk Management, reveal irregularities in the implementation of control procedures to the presentation of the Audit Committee for the implementation of its functions to evaluate the effectiveness of procedures of ICS;</li> <li>– assesses the quality of the regulation of business processes;</li> <li>– control the execution of internal control procedures of ICS reports and identified violations to the Audit Committee;</li> <li>– monitor correct the violations identified by the results of risk-oriented audits;</li> <li>– control documenting business transactions and their reflection in the system of accounts;</li> <li>– support and develop methodological and regulatory framework of ICS as well as approaches and criteria for evaluating its effectiveness;</li> <li>– during the implementation of the control environment coordinate standardization of business processes of the Company and assess</li> </ul>

<b>Participant</b>	<b>Duty</b>	<b>Functions and responsibilities</b>
		<p>the quality of regulatory control procedures;</p> <ul style="list-style-type: none"> <li>– provide interested parties with information about ICS.</li> </ul>
<b>Workers of departments</b>	<b>Executors</b>	<ul style="list-style-type: none"> <li>– perform control procedures in the frame of functioning of ICS in accordance with job description and the establishment of local regulations;</li> <li>– monitor the implementation of control procedures;</li> <li>– execute self-control procedures of effectively of performed control procedures and participate in the improvement of ICS;</li> <li>– inform officials and Sector for Internal Control and Risk Management on identified risks and irregularities in the functioning of business processes.</li> </ul>

## **5. Control procedures of ICS**

### 5.1. Types of control within the frames of ICS

The following types of control are performed within the frames of ICS:

1) **Preventive control.** It is performed before the beginning of business operations and is aimed at prevention and limitation of negative influence of events and factors that might endanger the achievement of strategic and business goals of the Company and its affiliated independent companies, procedures of preventive control are performed with the frame of works system of risk management of Company and its affiliated independent companies;

2) **Current control.** It is performed during business operations, aimed at achieving goals of business process and provision of effective using of resources while implementing business processes;

3) **Control at the end of operation.** It is performed after all business operations, aimed at revealing violations, drawbacks or positive experience, assessment of correspondence of business results to the goals.

### 5.2. Basic control procedures

Within the frames of **preventive control** the following procedures are performed:

- Control of choosing the external auditor for providing its independency and assessment of working plan of the external auditor;

- Analysis of business processes for revealing the “bottle necks”, assessment of existing control procedures, and also revealing lacking control procedures that absence leads to risks;

– Events on risks management of the Company and assessment of Sector of Risk Management.

Procedures of **preventing control** are specified in Policy of Risk Management of the Company approved by Company's Board of Directors.

Within the frames of current control the procedures that are part of business process are performed. Control procedures are specified in Regulations on control environment and risks in business processes approved by Board of Directors.

Procedures of current control are described in details in risk matrix and control procedures of business process that are annexes to regulations on control environment and risks of business processes approved by Board of Directors of the Company.

In the frames of **control at the end of operation** the following procedures are performed:

– Analysis and assessment of reliability of management and accounting (financial) reporting of the Company;

– Control of recording of financial and business operations and their appearance in system of accounting records;

– Analysis (monitoring) and assessment of efficiency and reliability of internal control system. Checking the presence of control procedures, recording and quality of performance;

– Compliance control aimed at providing the correspondence of Company's activity to legislation of Russian Federation, industry standards, internal normative documents including requirements on illegal use of insider information and market manipulation;

– Taking into consideration the results of investigations and measures taken by the Company for prevention of facts of fraudulent activities in the Company and preventing facts of corruption.

**Control procedures at the end of operation** are specified at Regulation on internal control approved by executive body of the Company.

## **6. Regulatory system and standards of Company in sphere of internal control**

Internal documents of the Company that govern ICS are worked out in accordance with present Policy.

Table 3 contains the necessary list of documents of ICS and their purposes.

### **Table 3. List of normative documents**

<b>Document</b>	<b>Document purpose</b>
<b>Policy of internal control</b>	Internal document of the Company that describes principles of organization and development strategy of Sector of Internal Control.
<b>Regulations on control environment and risks in business process (including risk matrix and control procedures)</b>	Internal document that describes control environment and risks in business process of the Company.
<b>Unified regulations, instruction, normative and reference materials</b>	Internal documents that govern Sector of Internal Control and that are obligatory fulfillment by all participants of Sector of Internal Control.
<b>Reporting forms on control procedures</b>	Reporting forms of Subdivisions of the Company on control procedures.
<b>Standards of internal audit</b>	Internal documents that govern method and procedure of internal control used by Sector for Internal Control and Risk Management while auditing procedures.

## **7. Strategy of development of system of internal control**

### **7.1. Internal control system development strategy**

Development and sophistication of system of internal control in the Company to be aimed at:

- Providing the insurance of correspondence of system of internal control to level of activity of the Company and complexity of business operations;
- Providing the protection of interests of shareholders, investors and other persons / entities;
- Usage the best international and Russian practice in sphere of internal control and risks management.

### **7.2. Process approach of internal control system**

Company is aimed at development of process-based activity management and creating the internal control system in order to reach:

- unification, optimization and effectiveness of business processes and organizational structure;
- well-balanced actions of structural subdivisions;
- synergetic effect from joint concerted activity of structural subdivisions and control authorities of the Company.

### **7.3. Levels of maturity of internal control system**

The level of maturity of internal control system in the Company is defined in accordance with following criteria:

#### **1<sup>st</sup> level. Standardized internal control system:**

- Simple policy is established;
- Control environment and business processes (procedures and mechanisms of control) are documented;
- Control procedures are performed and controlled;
- Control procedures are adopted to changes of internal and external environment;
- Internal audit carried out risk-oriented audit of single business processes;
- The best practices are distributed in the Company;
- Personnel training on internal control system enhancement are performed.

**2<sup>nd</sup> level. Optimized system of internal control:**

- policy is described in detail;
- routine and available for an analysis monitoring of implementation of control procedures and their sophistication by the results of audit;
- control procedures are adopted to changes of risks and always recorded;
- the method of documenting the control procedures was standardized;
- risk-oriented audit and monitoring of internal control system is carried out regularly.

**3<sup>rd</sup> level. Automated system of internal control:**

- control procedures are conformed to other control and audit functions;
- structure of Risk Management and internal control system are functioned as one integrated system;
- permanent enhancement of internal control system;
- control procedures were computerized;
- monitoring of performance of implementation of control procedures was computerized;
- monitoring of risks and efficiency of control procedures is performed on the basis of automated means of monitoring the key risks indicators.

In affiliated and dependent companies the strategy of development of internal control system is performed by the company by means of methods of corporate governance within the frameworks of observance of shareholders rights.

## **8. Final clause**

8.1. The Policy as well as all amendments and adjustments to it are to be approved by the Company BoD in accordance with internal documents of the Company.

8.2. Issues beyond governance of the policy should be settled by current legislation, decisions of the BoD, internal documents of the Company.

8.3. If in the results of changes in legislation and legal acts of RF the particular articles of the regulation come into conflict with them, then these articles lose their validity and till the moment of introducing adjustments to the Regulations the Company should follow the current legislation and legal acts of the Russian Federation.